

CONTRACTS RISK MANAGEMENT GUIDELINES



Prepared By
State of Alabama
Division of Risk Management
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CONTRACTS

RISK MANAGEMENT GUIDELINES

PURPOSE AND USE OF THESE GUIDELINES

These Guidelines are intended to provide an overview of recommended Risk Management Practices that may be used by State agencies when negotiating and executing contracts. They are intended as a guide in identifying and protecting the State and its employees from the physical and financial risks that may arise out of the contract and its execution. These Guidelines do not address the contractual issues relating to the nature of the work nor other technical issues not directly related to the exposure to liability and property loss.

Included in the Guidelines are recommended practices in these areas:

- Minimizing tort liability
- Hold Harmless agreements
- Insurance and bonding requirements
- Insurance certification and security
- Recordkeeping
- Consulting Services of Division of Risk Management (DORM)

Some State agencies have operations of such a nature that these Guidelines should be supplemented with additional legal and professional Risk Management attention. In such instances, DORM will assist by coordinating State resources to more fully address the need. Any State agency which encounters specific instances that require these additional services should contact DORM.

WHO TO CONTACT FOR ASSISTANCE

Should you wish assistance, contact the Division of Risk Management at 334-223-6120. If time permits, direct written questions and background material to:

Department of Finance
Division of Risk Management
777 South Lawrence Street
Montgomery, AL 36130-3250

Fax: 334-223-6154

To expedite inquiries, call any one of the following:

Hank Draughon:	334-223-6152
Max Graham:	334-223-6149
Ben Spillers:	334-223-6130

TORT LIABILITY

A tort is a civil wrong (as opposed to a criminal wrong). Tort liability arises when one causes injury or damage to another. Typically, liability is based on the negligence of the one responsible. The field of law dealing with torts is ever changing due to judicial interpretation, new theories of liability and the like. The trend is toward a greater expansion of liability under tort, with larger recoveries and more ways to seek those recoveries. Risk management techniques apply fundamental approaches to making tort liability a lesser part of the operating environment, thereby reducing financial risk.

Major Exposure Areas: Potential liability arises from injury to members of the public, damage to property, and injury to workers of either the contractor or the State. The operation of motor vehicles creates exposure to loss as well.

State Immunity: For the State of Alabama, this means the State cannot be sued in State Court for allegation of negligence by the State itself. This immunity is found in the Alabama Constitution and it is relied on by the State and by State officials acting in their official capacity.

State immunity does not protect State employees from legal actions for alleged negligence while performing their State jobs, and many suits are brought against employees in lieu of being brought directly against the State. State immunity may also possibly be circumvented by actions under Federal Statutes in Federal Courts or under Federal Administrative Rules.

State agencies should therefore always seek to minimize potential loss from liability that may result from the execution and performance of contracts.

Liability Loss Reduction Techniques

There is an array of techniques useful for minimizing exposure to liability. State agencies should be aware of them and utilize those that are appropriate in individual instances.

Competence of Performance: If the contractor hired is incompetent or reckless, a loss that results from the performance by that contractor may result in an action claiming negligence by the State agency in engaging the incompetent to do the work. Therefore, the hiring of a competent contractor is a risk reduction factor. Always evaluate the ability of the contractor, considering fundamentals such as capacity and capital to do the work, along with experience and past performance.

Inherently Dangerous Work: Some work is so inherently dangerous that any liability for loss arising from that work will not depend on negligence, but simply the fact that the loss occurred. The most instantly recognizable type of such work is blasting in populated areas. Liability for such work may be minimized by having others do it and by transferring the risk utilizing the insurance and hold harmless techniques later discussed.

Transfer of Risk: Risk of loss can normally be transferred to the contractor by a Hold Harmless Agreement and insurance provided by the contractor to protect the State and its employees. These are later discussed in detail.

THE CONTRACT

Bid Specifications: Be as specific as possible in describing the types of insurance required. This would include both liability and property coverages where applicable, as well as any surety requirements. Include the specific Hold Harmless/Indemnification agreement language that you will require. In case of construction contracts that fall under the supervision of the Alabama Building Commission (ABC) the applicable rules and procedures cover many of these items.

Contract Content: The contract should contain the hold harmless language and the specific insurance and surety requirements to which the parties agree. These requirements will include specific insurance terms and limits, notice to the State whenever insurance is reduced or terminated, certification of insurance, and standards for financial strength of the insurer or surety.

Contract Creation and Review: Before the contract is executed, the responsible contract officer should examine it for insurance and risk transfer implications.

Insurance Requirements: Assure that requirements of the State for Professional Liability, General Liability, Business Auto Liability and Workers' Compensation are clearly stated and reasonable. Any Surety requirements should also be spelled out. Complex and onerous requirements may not be suitable for a simple non-hazardous services contract, but be entirely appropriate for a complex, potentially dangerous job. For example, use judgment when deciding whether the State should be named as an additional insured on the contractor's policy. In certain instances this might be overkill.

Make it clear in the contract that evidence of insurance must be in the State's hands prior to work commencing.

Hold Harmless Agreement: This agreement should be clearly stated and reasonable, and should provide protection to the State and others, as needed. Forms provided by vendors or other contractors should be examined carefully. When a Hold Harmless Agreement is used, the contract should state that the required insurance will cover insurable obligations of the agreement.

Insurance Cost Pass Through: In some instances, a provider may buy insurance and include its cost in the contract. For example, if the contract is a lease of premises agreement, be alert to obligations to pay for insurance on property being rented by the State. The owner should insure his own property, and normally there should be no direct pass through of such cost to the State.

Requirement for the State to Provide Insurance: Decline to agree to provide liability insurance to someone else, for example, the owner of equipment being leased. Similarly, decline to provide physical damage insurance, unless the trade-off is clearly favorable, i.e. the reduction in lease cost is greater than the cost of insurance the agency will have to purchase.

HOLD HARMLESS AGREEMENTS

Hold Harmless Agreements, also known as Indemnity Agreements, may be used to deal with a variety of contract situations. Specific contract situations may sometimes be best met by a Hold Harmless Agreement specifically designed for that type situation.

Examples are:

- Construction Contracts
- Lease of Premises
- Purchase Order for services or products
- Equipment Lease

In addition to transferring risk from one party to another, a contractual Hold Harmless Agreement provides considerable value to both parties, in that the agreement can clearly define legal responsibility. This adds certainty to the transaction and can help the parties avoid extraordinary legal costs in sorting out responsibilities. Resolving responsibility for liability by the terms of a contract has distinct advantages over being forced to resolve such questions through the courts.

Category of Hold Harmless: The degree of hold harmless may generally be sorted into three categories. Keep in mind that in the following examples the indemnitor is the party contracting with the State, the indemnitee.

- **Broad.** Such an agreement would attempt to have the indemnitor (the contractor, for example) hold the indemnitee (the State) harmless for all tort liability arising from the contract, regardless of who was negligent. The terms would make the indemnitor responsible for liability for any injury or damage arising out of the contract, even if caused by the sole negligence of the indemnitee.

Though Alabama courts have allowed this general approach to transfer of risk under specific circumstances, it has been found to be unenforceable in numerous jurisdictions as overreaching the bounds of good public policy.

- **Intermediate.** Such an agreement would address situations caused by the negligent actions of the indemnitor either solely or in concert with the concurrent negligence of the indemnitee. For example, if an action alleges negligent supervision by the State and negligent actions by the contractor, this type of Hold Harmless Agreement places responsibility on the indemnitor for all the resulting liability.

Responsibility for injury or damage arising from the sole negligence of the State or its employees would not be transferred to the indemnitee by this level of agreement.

- **Limited.** This type of agreement seeks to make plain by contract that the indemnitor is fully responsible for the consequences of his own negligence. While seemingly redundant, this approach gives the indemnitee the advantages of contractual terms that evidence, in writing, the meeting of minds of the parties as respects liability. Invoking the rules of contract law might well clarify responsibilities and change their impact on the parties.

In examining Hold Harmless Agreements, focus on what level of responsibility for negligence is to be transferred by contract,

1. Sole Negligence (Broad). The State has transferred responsibility for all liability arising from the performance of the work which is the subject of the contract.
2. Joint/Concurrent Negligence (Intermediate). The State remains responsible for its sole negligence while any Joint and/or concurrent negligence that results in liability is transferred.
3. Limited. There is no transfer of liability from the State. However, the contract terms make the determination of responsibility more predictable and certain.

Recommended Level of Risk Transfer: The Division of Risk Management believes most significant State of Alabama contracting situations would call for an Intermediate level of Indemnity/Hold Harmless Agreement. Thus, the State and its employees would be responsible for the sole negligence of the State, and the contractor would be responsible for joint/concurrent negligence, along with his own sole negligence. If a Broad form of transfer is desired, much care in drafting the entire agreement is required.

INSURANCE

Contract language similar to the following should be included to create specific contractual responsibility to secure and maintain adequate insurance.

“The contractor agrees to secure and maintain insurance of the following kinds and amounts in addition to any bonds required under the terms of the contract specifications. All insurance shall be provided by insurers licensed in Alabama to provide the types of insurance required and insurers must be rated “A-“ or better by the A.M. Best Company. Before beginning work, the contractor shall have on file with (your agency name) a valid Certificate of Insurance showing the types and limits of Insurance carried.”

Recommended Contractual Insurance Requirements

Applicable sections of these recommendations on insurance coverage and terms should be included both in the contract specifications and the contract. Require delivery of a Certificate of Insurance to validate that coverage is in force.

A. GENERAL LIABILITY INSURANCE

- 1) Policy Coverage. All liability insurance will be provided by the Insurance Services Office (ISO) Commercial General Liability Coverage form (current edition as of the effective date of the contract) on an “occurrence” basis, or an equivalent liability form that is at least as broad.
- 2) Limits Required.
 - General Aggregate \$2,000,000
 - Products-Completed Operations Aggregate \$2,000,000
 - Each Occurrence \$2,000,000
 - Aggregate Limits of Insurance per Project.
The general aggregate limit shown above will be applied separately to each construction project away from the insured’s premises and the policy will be amended accordingly. (Utilize this provision for construction projects of significant size or duration.)
- 3) This insurance will apply to insurable obligations of the Hold Harmless Agreement and the Commercial General Liability policy will not be restricted in this respect.
- 4) Policy Endorsement. The policy will be amended as follows:
“This policy expressly provides:
 - i. “Insured contracts” coverage applies to contracts of the Insured with the State of Alabama and (your agency name)
 - ii. In the event of cancellation or material reduction in coverage, thirty (30) days registered mail notice of such cancellation or material Reduction will be given to (your agency name).

- 5) Additional Insured. *(Your agency name)* and their employees will be named as “additional insureds” on contractors’ General Liability policies. Coverage will be written on an ISO Occurrence Form or equivalent coverage.

B. AUTOMOBILE LIABILITY INSURANCE

- 1) Policy Coverage. All auto liability insurance will be provided by the ISO Business Auto Coverage form or an equivalent automobile policy that is at least as broad.
- 2) Autos covered. Any auto. Coverage will therefore apply to any automobile operated by or on behalf of the contractor.
- 3) Limits required (either option).

• Combined Single Limit			\$1,000,000
• Split Limit	BI	Per Person	\$1,000,000
		Per Accident	\$1,000,000
	PD	Per Accident	\$1,000,000

A. WORKERS’ COMPENSATION INSURANCE

- 1) Policy Coverage. Standard Workers’ Compensation.
- 2) Limits. Alabama Statutory benefits.

B. PROFESSIONAL LIABILITY/ERRORS AND OMISSIONS INSURANCE

Certain types of services are not appropriately insured by General Liability Insurance since the services are of a professional nature and are more likely to arise from a professional error than from a clear cut negligent act. Therefore, contracts dealing with professional services such as medical care, engineering design, and architectural design, are insured with a professional liability form. General Liability Insurance is unlikely to provide the proper insurance response.

Professional Liability coverages are typically highly specialized, with unique policy language that addresses the profession covered.

Key areas to address:

- Adequate limits. Use General Liability Limits as a guide.
- “Occurrence” or “claims-made” form. Review the glossary. A claims made form is normally suitable if continuous coverage is assured.
- Financial Security of the insurance company. Professional Liability/E&O Insurance may be provided by specialty insurers. Careful attention to the financial strength of the insurer is often warranted.
- Breadth of coverage assures the policy covers the professional activities being contracted for.

C. COMMERCIAL UMBRELLA/EXCESS COVERAGE

- 1) Limits Required
 - Combined Single Limits \$15,000,000
- 2) Coverage should apply as excess over the coverage provided by the Commercial General Liability and Business Auto Liability coverages.
- 3) It may be desirable at times to obtain excess coverage for Professional Liability/E&O exposures as they are not generally covered by standard Umbrella/Excess policies. These coverages are more specialized and should be considered on a case by case basis.
- 4) It is helpful, in determining the amount of liability coverage needed, to calculate the Maximum Probable Loss (MPL) that might arise out of the performance of the contract. For example: If renovations are being done on a building whose value, including contents, is \$5 million, it is probably desirable that the contractor(s) have at least this much coverage in case of a loss which severely damages or totals the property.

D. OWNERS AND CONTRACTORS PROTECTIVE INSURANCE

This is coverage for an insured that hires an independent contractor or subcontractor to work on a construction project.

Since the insured is typically responsible for the safety of the jobsite, the insured can transfer that obligation to the contractor/subcontractor and require that they be named as an additional insured on the contractors/subcontractor's General Liability policies. If the contractor/subcontractor loses their General Liability coverage or if their policy limits are exhausted by another loss, an Owners and Contractors Liability Policy could provide the additional protection needed.

An Owners and Contractors Protective Liability policy provides for payment on behalf of the insured of all damages the insured becomes legally obligated to pay due to bodily injury or property damage caused by an occurrence arising from the following:

- 1) Operations performed for the named insured by independent contractors.
- 2) Acts or omissions of the named insured in connection with its general supervision of such of such operations.

E. SURETY AND OTHER BONDS

Often with construction projects, a need exists to have a third party assure the performance or obligations of one party to another party. A Surety company could be the "third party" that provide these assurances in return for premium payments.

For example, in order to obtain a contract to build a project, the general contractor (and often the sub-contractors as well) must provide the owner a bond for its performance of the terms of the contract. Conversely, owners and contractors may also provide payment bonds to ensure that subcontractors and suppliers are paid for work done.

It is common for private and public entities, such as corporations, universities, and federal and state governments, to require surety bonds, in the form of performance bonds and other bonds, to manage the risk on construction projects. A performance bond is a three-party agreement consisting of the project owner, the contractor, and the surety company. This bond protects the project owner from financial loss should the contractor fail to perform the construction contract in accordance with its terms and conditions.

OTHER INSURANCE ISSUES

The above remarks address required liability and Workers' Compensation insurance. Contracts may also give rise to property loss exposures. The parties need to have a meeting of minds as to which provides the insurance and on what terms. Examples would be:

Builders Risk: Course of construction coverage may be provided by either party. Cost factors for this coverage can vary substantially, as well as terms of coverage and how coverage coordinates with permanent insurance. Always contact the Division of Risk Management for guidance to assure cost is reasonable and there are no coverage gaps. It is desirable to have Builders Risk coverage in an amount equal to at least 100% of the contract sum.

Leased Premises: The parties may mutually agree whether lessee or lessor will insure premises. If the lessor is to insure, and the cost is a direct pass through to the State agency, have DORM review the proposal for cost effectiveness. This will help avoid situations here the cost pass through is excessive.

Equipment and Automotive Leases: Whenever the parties agree the lessor is to provide physical damage insurance, have Dorm review the proposal for reasonableness. In most instances, an agency should not agree to insure the liability interest of the lessor.

Waiver of Subrogation: We do not recommend that you waive subrogation rights as to damages which might be caused by the contractor, lessor, etc. Should you waive this right of recovery you could jeopardize any property coverage you may have with the State Insurance Fund.

ADDITIONAL INSURED

In many cases it is appropriate for the contracting party to extend insurance coverage to apply on behalf of State agencies. In construction contracts it is usual and customary that the State and its employees have extended to them the liability protection for both general liability and automobile liability. The cost is usually nominal or nothing. However, care must be taken to assure significant pass through costs are not generated and built into the contract.

The rationale for this approach is that the contractor normally has full control of the job site and little additional exposure to his insurer is created by the additional insured approach. See Appendix Page i for appropriate terminology to add to the model Certificate of Insurance.

Purchase order agreements also lend themselves to the additional insured treatment. The contractor has control of the goods and services and little additional exposure is created by covering the State agency.

SUMMARY

- Be alert and aware of potential liability to the Agency and/or its employees and provide contractually for an appropriate level of protection by the contractor. Concurrently, avoid overly rigorous requirements not in keeping with the exposure arising from the work.
- Assure all contract terms that relate to risk transfer or liability or property insurance requirements are complete and clearly stated. Assure the contractor carries reasonably complete insurance.
- Utilize risk transfer techniques where appropriate:
 - Require Hold Harmless Agreements
 - Have contractor's liability policy cover the agency and employees as additional insured.
- Utilize Certificate of Insurance to validate insurance coverage is in place.
- Utilize the Division of Risk Management as advisor to assure your objectives are met. Call 223-6120.

APPENDIX

CERTIFICATE OF INSURANCE

Included is a model Certificate of Insurance that may be adapted to the use of any specific agency. Follow these guidelines:

1. Assure all blanks in the form that apply are fully completed. Be sure to insert your agency name and address at the top following "State of Alabama" and that the bottom following "given to".
2. Maintain a diary if the contract extends beyond the insurance policy period and secure a renewal certificate.
3. Assure the "Description of Operations" is specified. Reference to the contract number will help.
4. Consult DORM if the financial security of the Insurance Company is in question.
5. Maintain the Certificate of Insurance at least 10 years. If the subject of the work is long lived, maintain the Certificate indefinitely.

Additional Insured.

To activate on the certificate your requirement to be named as an additional insured under the contractor's policy this or similar language should be added: "As respects General Liability Insurance, the State of Alabama, (your agency name), and their employees are named as additional insureds."

APPENDIX

MODEL CONSTRUCTION CONTRACT HOLD HARMLESS AGREEMENT

This agreement is intermediate, i.e. all liability is transferred to the contractor except that arising out of the sole negligence of the State or State employees. Responsibility for negligence that is joint and concurrent by the State, its employees, and the contractor is assumed by the contractor.

The precepts sample in this agreement may be utilized to construct hold harmless agreements that are applicable to other types of contracts.

Indemnification/Hold Harmless Agreement

To the fullest extent permitted by law, the Contractor shall defend, indemnify, and hold harmless the Owner, Architect, Architect's consultants, Alabama Building Commission, State Department of (your entity) , and their agents, employees, and consultants (hereinafter collectively referred to as the "Indemnitees") from and against all claims, damages, losses and expenses, including but not limited to attorneys' fees, arising out of, related to, or resulting from performance of the Work, provided that such claim, damage, loss or expense is attributable to bodily injury, sickness, disease or death, or to injury to or destruction of tangible property, including loss of use resulting therefrom, and is caused in whole or in part by negligent acts or omissions of the Contractor, a Subcontractor, anyone directly or indirectly employed by them, or anyone for whose acts they may be liable, regardless of whether such claim, damage, loss or expense is caused in part, or is alleged but not legally established to have been caused in whole or in part by the negligence or other fault of a party indemnified hereunder.

- A. This indemnification shall extend to all claims, damages, losses and expenses for injury or damage to adjacent or neighboring property, or persons injured thereon, that arise out of, relate to, or result from performance of the Work.
- B. This indemnification does not extend to the liability of the Architect, or the Architect's Consultants, agents, or employees, arising out of (1) the preparation or approval of maps, shop drawings, opinions, reports, surveys, field orders, Change Orders, drawings or specifications, or (2) the giving of or the failure to give directions or instructions, provided such giving or failure to give instructions is the primary cause of the injury or damage.
- C. This indemnification does not apply to the extent of the sole negligence of the Indemnitees.

APPENDIX

GLOSSARY

ADDITIONAL INSURED – A person other than the named insured who is protected under the terms of the contract. Usually, additional insureds are added by endorsement or referred to in the wording of the definition of “insured” in the policy itself.

AGGREGATE LIMIT – Usually refers to liability insurance and indicates the total limits that the insured has under the contract for a specific period of time, usually the contract period, no matter how many separate accidents may occur. For construction contractors this limit may be stated to apply to each job, thereby avoiding unintended erosion of limits.

BODILY INJURY LIABILITY – A legal liability that may arise as a result of the injury or death of another person.

CLAIMS-MADE COVERAGE - A policy written on this basis covers only those claims which are reported during the policy period. When the insured renews the claims made form, coverage for prior acts is provided back to the retroactive date (the effective date of the original claims made policy with the same insurer). This coverage approach is often used for professional liability insurance.

CERTIFICATE OF INSURANCE – A form which verifies that a policy has been written and states the coverage period.

COMBINED SINGLE LIMIT – A single limit of protection for both bodily injury and/or property damage, contrasted with split limits, where specific limits apply to bodily injury or property damage separately.

HOLD HARMLESS AGREEMENT – A contractual arrangement whereby one party assumes the liability inherent in a situation, thereby relieving the other party of responsibility. Also known as an Indemnity Agreement.

INSURANCE SERVICES OFFICE (ISO) – A statistical and forms organization. ISO policy forms are often considered the benchmark standard.

LIMITS OF LIABILITY – The maximum amount for which an insurer is liable as stated in the insurance policy.

OCCURRENCE COVERAGE - A provision which specifies that coverage applies to all injuries arising out of occurrences during the policy period regardless of when the claim is made.

Risk Management Checklist for Contracts

Project Name/Purchase _____

Type of Contract: Construction Services (specify) _____
 Purchase Lease (specify) _____

Insurance Company Ratings, Coverage and Limit Guidelines

Best Secure Rating: A- or better

Best Financial Size Category: Class VI and higher

Coverage		Limits Guidelines		Approved Amount	N/A
Form	Basis	High Risk	Low Risk		
CGL	Occurrence	\$2 million	\$1 million		
	Aggregate	\$2 million	\$1 million		
Bus. Auto	Occurrence	\$2 million	\$1 million		
WC & Empl. Liab		Statutory Limits			
Prof Liab/E&O	Occurrence*	\$5 million	\$1 million		
	Aggregate*	\$5 million	\$1 million		
Owners & Contractors Protective	Occurrence*	\$2 million	\$1 million		
	Aggregate*	\$2 million	\$1 million		
Umbrella/Excess	Occurrence	\$15 million	\$2 million		
*Claims Made		5 year tail	3 year tail		
Bonds	Surety(Performance)			100% of Contract	
	Payment				
Builders Risk		Completed Project Value			
Property		Full Replacement-No Coinsurance			

Indicate approved amount unless recommended coverage is not applicable (NA).

CERTIFICATE OF INSURANCE

This is to certify to the State of Alabama, that the described policies are in force.

Insurance Company

Insured

Address of Insured

Description of Operations/Locations/Vehicles: Special Provisions

TYPE OF INSURANCE	POLICY #	POLICY PERIOD	LIMITS OF LIABILITY
STANDARD WORKER'S COMPENSATION			Alabama Statutory Requirements
GENERAL LIABILITY Commercial General Liability Occurrence Form			Per Occurrence \$ _____ Products/Completed Operations Aggregate \$ _____ General Aggregate \$ _____
Professional Liability <input type="checkbox"/> Claims Made <input type="checkbox"/> Occurrence			Per Claim \$ _____ Per Occurrence \$ _____ Aggregate \$ _____
AUTOMOBILE LIABILITY Any Auto			Combined Single Limit \$ _____ Bodily Injury (per person) \$ _____ Bodily Injury (per accident) \$ _____ Property Damage \$ _____
EXCESS LIABILITY <input type="checkbox"/> Umbrella Form <input type="checkbox"/> Other Excess			Each Occurrence \$ _____ Aggregate \$ _____

In the event of cancellation of or material reduction in coverage, thirty (30) days' registered mail notice of such cancellation or material reduction will be given to:

Name of Local Authorized Representative

Date Issued

Address

Signature of Local Authorized Representative