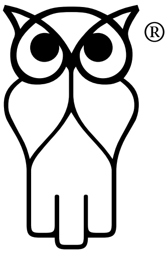

IRMI® Insights

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Sound Advice for Contract Drafters: Fix Your Out-of-Date Insurance Requirements!

By Jack P. Gibson, CPCU, CRIS, ARM *November 2010*

Most business contracts (e.g., construction contracts, leases, purchase agreements, service agreements) include clauses that require one or both parties to purchase certain minimum levels of insurance. The basic purpose of this is twofold:

- To make certain that one party has the resources to pay a claim made against it by the other contracting party or to repair damage to the property involved with the contract (e.g., a lease) or to replace it when destroyed.
- To fund the obligation to indemnify the other party that is so commonly included in hold harmless clauses in contracts (or, in addition to the hold harmless, to provide additional insured status in the other party's policy).

While the basic goals are simple, a preponderance of contract drafters botch the job. Why do so many contract drafters consistently foul up on the insurance requirements they impose on vendors, contractors, and others to the point that they are impossible to meet? A major cause is that their insurance clauses require antiquated and outdated insurance policies or policy modifications that are no longer even available in the insurance marketplace!

This happens all too frequently due to lack of knowledge or simple laziness. Contract drafters are usually business people or attorneys who are quite knowledgeable about the subject of the contract or the law but in the dark about insurance coverage and what can be realistically achieved in the insurance marketplace. Thus, they often just copy contract terms that were drafted previously without either taking time to review the insurance clause and update it or seeking assistance in doing so if they do not have the knowledge.

About the Author

Jack P. Gibson, CPCU, CRIS, ARM, is president of International Risk Management Institute, Inc. For most of his 32-year career as a researcher, lecturer, and author on risk and insurance topics, contractual risk transfer has been a major focus. He is coauthor of *The Additional Insured Book* and *Contractual Risk Transfer,* as well as nine other titles in the IRMI reference library. He is also cochairman of the IRMI Construction Risk Conference.

Since this happens over and over again, many contracts rely on insurance terminology that has been out-of-date for decades! Though very common, this is an inexcusable error in contract drafting.

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This article describes the issue, why it is a problem for the drafter's company as well as for the lessee, vendor, or contractor, and why it results in an immediate breach of contract situation upon execution of the agreement. It then provides simple, straightforward advice to contract drafters who wish to assure their organizations are properly protected.

Why this Is an Issue

Insurance clauses essentially require one or more of the contracting parties to arrange an insurance program that will provide a certain scope of protection to the other party. Since reputable business entities buy and maintain broad insurance programs on an ongoing basis, ideally the stipulated insurance will require little or no adjustment to the existing insurance program of the contracting party. When, however, the clause requires policy form types or a level of coverage that are difficult to obtain or not available in the marketplace, the party agreeing to the requirement will be placed in an untenable position—essentially in breach of the contract with little or no means to cure the breach.

When this occurs, one of two things happens: (1) no one realizes that the current insurance program is not in compliance with the requirement, and everyone unknowingly goes about their business; or (2) someone representing the organization that has agreed to the improper requirement tries in vain to obtain the required policies or amendments to the existing policies and realizes that it cannot be done. Such situations are not good for either contracting party.

In the first instance, all is bliss until some horrific accident requires everyone to pull out the insurance policies only to learn that they do not provide the coverage that was thought to be in place. This results in further complications, including coverage disputes and possible lawsuits with the insurers and between the contracting parties.

In the second case, a post-contract negotiation process begins as the parties seek to compromise with each other and the insurer on the scope of insurance to be provided. This can be a time-consuming and costly process

Contractual Risk Transfer Resources from IRMI

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- *The Additional Insured Book*—the bestselling book
- Effective Contractual Risk Transfer in Construction—a free whitepaper
- Contractual Risk Transfer in Construction—an online CRIS® course

that is entirely avoidable when these clauses are properly drafted in the first place.

How It Happens

Insurance policy terms are not static as the policies are continuously revised by the insurance industry. Many contract drafters do not realize just how frequently insurance policies are revised or the extent to which changes are incorporated when they are revised. Most insurers use standard policy forms drafted by a service organization such as Insurance Services Office, Inc. (ISO), American Association of Insurance Services (AAIS), and National Council on Compensation Insurance (NCCI). These policy form drafters continuously revise their forms in response to court rulings that interpret them and changes in business practices, the environment, and exposures to loss. The revised forms are then filed with insurance regulators and the replaced forms are withdrawn, often making it a violation of the insurance code for an insurer to use them any longer.

The policy form that has changed the most over the years is also the most critical one to get right in contracts: the commercial general liability (CGL) policy. This is the policy that covers the insured's liability to third parties, including contractually assumed liability. Since it is one of the most important policy forms for contractual risk transfer purposes, these revisions can be quite problematic. Consider that there was a standard CGL form in place from 1973 until 1986, some 13 years. Since the 1986 revision, the policy has been revised about every 3 years (between 1986 and 2010 there have been 8 revisions).

Each of these policy revisions has made many insurance requirements drafted prior to the revision out-of-date. However, the most significant changes were undoubtedly those that were implemented in 1986. They were so significant that even the name of the policy was changed (from "*comprehensive* general liability" to "*commercial* general liability").

It is extremely common to see insurance clauses that require the 1973 CGL policy form rather than a newer version.

Since the 1986 revision was implemented some two and a half decades ago, you might think that these changes would be reflected in the insurance requirements of most modern-day business contracts. Due largely to incessant replicating of old contract language year after year, decade after decade, that is, unfortunately, not the case. It is extremely common to see insurance clauses that require the 1973 CGL policy form rather than a newer version. They do this by requiring the purchase of a comprehensive (as opposed to "commercial") general liability insurance policy. Making matters worse, they then go on to stipulate that a number of coverage extension endorsements that were necessary with that 1973 policy be attached. The extensions included in these endorsements have been built right in to modern-day CGL forms, and the endorsements are no longer available (in fact, many insurance underwriters are young enough that they have never even seen them!).

The problems caused by outdated terminology in contracts are most severe with CGL insurance. However, mistakes are also common when requiring other lines of insurance.

How To Quickly Spot the Problem

It's a fairly simple matter to identify antiquated insurance requirements in contracts. Knowing a few key words to look for is all it takes, and a checklist of the most common antiquated terms is provided in Figure 1. Consider any of these terms to be red flags—when they are used in a contract, the entire insurance clause should be suspect. Clauses using such terminology achieve little other than wasting time, causing disagreements, or even leading to lawsuits down the road.

How To Draft Solid Insurance Requirements

Some basic objectives of contract insurance clauses include the following.

(1) Require insurance coverage terms and limits that will specify the scope of protection warranted to cover the primary risks associated with the business endeavor to which the contract pertains.

(2) Avoid imposing requirements that cannot be achieved in the insurance marketplace.

(3) Keep the requirements as understandable, simple, and easy to implement as possible.

(4) Recognize that the other party already has an insurance program in place and try to avoid imposing requirements that would require them to renegotiate their program with their insurers.

(5) Allow the other party a reasonable amount of flexibility with respect to how they meet the overall requirements.

Figure 1
Red Flag Insurance Terminology

Liability Insurance Requirements

- Comprehensive general liability insurance
- Public liability insurance
- Manufacturers and contractors (M&C) liability insurance
- Owners, landlords, and tenants (OL&T) liability insurance
- Contractual liability insurance
- Additional named insured
- Coinsured
- Cross-liability endorsement
- Broad form comprehensive general liability (CGL) endorsement
- Broad form property damage endorsement
- Combined single limit (CSL)

Auto Insurance Requirements

- Comprehensive auto liability insurance
- Additional insured or coinsured status (other than for a lessor of a vehicle)
- Cross-liability endorsement

Workers Compensation Requirements

- Workmen's compensation insurance
- Borrowed servant endorsement
- All states coverage/broad form all states coverage endorsement
- *In rem* endorsement

Property Insurance Requirements

- Fire and extended coverage or extended coverage endorsement
- Additional named insured

(6) Minimize the possibility that the requirements will become outdated during the term of the contract due to insurance market changes and policy form revisions.

To achieve these basic goals, a number of tactics should be considered, as follows.

(1) Perform a risk analysis on the business endeavor and decide how the risk could best be allocated between the parties.

(2) Outline the insurance requirements using this risk analysis and allocation plan as a guideline.

(3) Set minimum coverage standards by requiring coverage that is the same as or substantially equivalent to standard policy forms that are referred to by specific name and form number.

(4) Specify coverage forms but not exact edition dates to allow for the possibility that later editions will be introduced during the term of the contract.

(5) Specify a total liability insurance limit that can be met by any number of layered policy forms rather than minimum underlying CGL limits and a specific umbrella limit.

(6) Avoid specifying a maximum deductible amount for liability insurance.

(7) Avoid requiring any coverage modifications for which there are no endorsements in standard forms portfolios.

About IRMI®

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Unfortunately, there are no shortcuts for drafting insurance contract clauses that impose achievable requirements and provide adequate protection to the contracting party. Doing so requires careful review and drafting by a person who is knowledgeable of insurance coverage and what is reasonably achievable in the marketplace existing at the time the contract is drafted.

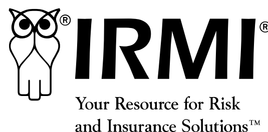
If your broker couldn't meet your requirements for their clients, you shouldn't expect others to be able to meet them either.

If you are a contract drafter, you must either utilize an adviser who has this knowledge or acquire and maintain this knowledge yourself. Most attorneys do not keep up with current insurance market practices and are therefore unable to provide realistic suggestions. Therefore, the best advisers are generally either insurance agents/brokers or fee-based consultants. If you haven't asked your own agent or broker to review the requirements you impose on others, this can be a very helpful approach. If your broker couldn't meet your requirements for their clients, you shouldn't expect others to be able to meet them either.

If you wish to acquire and maintain the knowledge for drafting contract insurance requirements, consider subscribing to *Contractual Risk Transfer.* This IRMI reference service drills into all aspects of the topic, covering indemnity and hold harmless clauses, additional insured status on insurance policies, contractual liability insurance, the use and abuse of insurance certificates, and much more. Most relevant to the topic of this article, it includes boilerplate insurance requirements to adapt for your own purposes.

Summary

Too many business contracts being used today include insurance clauses that use outdated, ambiguous, and misleading insurance terminology. The result is a contract provision that does not achieve its purpose and can lead to costly disputes or legal battles. With a little homework and due diligence, these provisions can be updated to better protect the party imposing the requirements while reducing the burden on the party accepting them. This is truly a win-win proposition for everyone, and there is no excuse for failing to do it.



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