MAY I HAVE THIS DANCE? – TO WRAP OR NOT

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I. INTRODUCTION

Construction complexity is rapidly increasing, and the roles assumed by owners, contractors and subcontractors are continually evolving. As construction projects have become more involved, project owners and contractors have increasingly sought to enhance their control over the risk associated with the project. As such, owner controlled insurance programs (OCIPs) and contractor controlled insurance programs (CCIPs), commonly referred to as "wrap policies," though once reserved for large, commercial projects with construction costs in excess of $50 million, have become far more prevalent and are being employed for construction projects of all sizes. While wrap policies have been available for over 40 years, their use has significantly increased over the past decade, in part due to the proliferation of construction defect litigation and projects owners and contractors desire to exercise more control over the risk management associated with their projects.

A Wrap Up program is commonly understood to be a single insurance program which covers all, or most, construction participants as insureds on all general liability and/or workers compensation risks associated with a given project. The named insured under the wrap policy would include the owner and or developer, general contractor and all subcontractors and may cover a single project, or in some cases, multiple projects. Therefore, under a wrap policy, one party procures insurance on behalf of all other parties working on the project. The wrap policy is either administered by the owner (thus, an OCIP) or the general contractor (thus, a CCIP). Simply put, a wrap up policy is designed to cover comprehensive general liability exposure for all claims arising from the construction project and covers all contractors and subcontractors working on the job.

The wrap policy model is a significant departure from the "traditional" construction model, which requires each contractor and subcontractor to secure their own insurance policy for personal injury or loss as a result of the construction work. In this type of traditional model lower-tier subcontractors generally name the general contractor as an additional insured and provide a broad indemnity agreement absolving the general contractor for losses sustained during the work on the project. The general contractor also provides a similar indemnity agreement to the owner and similarly names them as an additional insured. This type of model pushes the risk involved with a project downhill to the multitude of subcontractors that are involved on any one project. In turn, however, subcontractors build increased policy premiums into their cost structure, which becomes part of their bid for any proposed project. Therefore, by accepting a general contractor's bid, the owner often indirectly pays for the administrative overhead associated with the individual premiums secured by the various subcontractors. A wrap policy, however, provides uniform coverage that protects the developer, general contractors, subcontractors and sub-subcontractors for the designated project or projects. In addition to consolidating all insureds into a single policy, these policies typically provide completed operations coverage for a period of ten years from the date of completion, thus eliminating the need to purchase continuing policies for the duration of exposure for defect claims.

The following discussion predominantly focuses on OCIPs, which comprise the vast majority of "wrap up" programs currently offered in the United States. The use of wrap policies continues to grow in popularity for both residential and commercial projects. As wrap up policies have become more pervasive within the construction industry in not only the United States, but also abroad, it is important to analyze the benefits and risks that are commonly associated with them.

II. Owner Controlled Insurance Program

A. <u>What is an OCIP?</u>

An OCIP is a wrap policy under which a project owner provides comprehensive coverage to contractors and subcontractors during the construction or renovation of a property, and is typically designed to cover virtually all liability and loss arising from the construction project. OCIPs comprise the vast majority of wrap policies currently offered in the United States.

Although each OCIP is individually negotiated between the owner and the insurer, the policy package generally contains general liability insurance, workers compensation insurance (including employer's liability coverage) and builder's risk insurance. Often, the OCIP is negotiated to provide coverage for most, if not all, bodily injury or property damages arising out of the construction, regardless of how the loss occurs. The job site is often defined to include not only the construction site itself, but also storage areas, lay down yards and on-site fabrication.

The majority of negotiated OCIPs are designed as multi-year programs with fixed durations and can cover a particular or multiple job sites. OCIPs can be negotiated to include additional coverages such as builder's risk, professional liability for design professionals, and environmental liability insurance coverages.

The OCIP is typically negotiated to cover all contractors, subcontractors and sub-subcontractors working on the project job site. However, all contractors are generally required to take affirmative steps beyond negotiating the construction contract itself, to properly enroll in the OCIP and enjoy coverage. Overall, there are benefits and detriments of OCIPs for both owners and contractors.

B. Benefits of an OCIP for an Owner.

Primarily, the decision to implement an OCIP is done with the goal of reducing overall insurance costs for the owner. Through an OCIP, an owner has the ability to combine the insurance premiums traditionally paid by general contractors and subcontractors and negotiate directly with an insurer to cover the entirety of the project. This direct negotiations with the insurer allows costs savings to the benefit of the owner through premium credits for volume purchasing, the elimination of contractors' mark-ups, and reduced litigation. This is combined with expected savings from coordinated safety efforts and enhanced claim management, which ultimately should result in a favorable loss experience. Generally, some studies show that OCIP coverage can typically reduce the owner's overall project costs by approximately two percent compared to the traditional, fragmented policies purchased individually by each contractor and subcontractor. Overall, OCIPs are used as a risk management tool for construction projects having very specific cost and risk characteristics.

For owners, a benefit of an OCIP is that it allows the owner to negotiate directly the terms of coverage with the insurer. This ensures that the site is adequately protected not only during the period of construction, but also well beyond the completion of the job. As stated above, risk transfer strategies have traditionally relied upon contractual and insurance relationships between the owner, general contractor and subcontractors. In the traditional model, the owner relies heavily on the ability of the general contractor to procure the correct and adequate insurance from the subcontractors not only through the completion of the project, but also throughout the duration of the exposure to construction defect risks. This reliance upon the general contractor thus extends far beyond the completion of the project and after the owner and general contractor no longer have a business relationship. Therefore, unlike with the traditional model, through an OCIP, an owner can negotiate broad, known insurance coverage that extends well beyond the completion of the project itself.

Furthermore, OCIPs provide improved risk management which is ultimately dictated by the policy negotiated by the owner and the insurer. Through an OCIP, the risk associated with a construction project become centralized through a single insurance program administered by the owner. There is less allocation of blame for any third-party injury or property damage suffered, as all participants are named insureds under the same policy. Accordingly, disputes or losses among the various contractors required to complete a job are resolved within the confines of the OCIP policy itself. This allows the owner to have control over administration costs by dealing with an insurer directly. Furthermore, this allows for a consolidated claims process between the owner and the claim, which can reduce associated litigation costs through early resolution. By consolidating all of these functions into a single OCIP controlled by the owner, risk is more properly managed with a focus on the potential liability of the owner itself.

C. Disadvantages of an OCIP for an Owner.

The management of OCIP program can oftentimes present a significant administrative burden to the owner. Specifically, if an OCIP is not adequately managed or overseen, significant additional losses can accrue. Consequently, the additional administrative burdens associated with the OCIP are at times outsourced to an insurance agent or broker, risk management consultant, or a third-party administrator. This cost of outsourcing the administration of the OCIP, however, can oftentimes be significant. The outsourcing costs generally include: employing or contracting an OCIP administrator, conducting a feasibility study, issuing detailed requests for proposals from contractors specific to OCIP requirements, and negotiating rates and scope of coverage with potential insurers. There also may be an administrative impact on an owner's operations because a number of departmental resources (e.g., legal, human resources, accounting, finance, purchasing, facilities and construction, safety and risk management) are affected throughout OCIP implementation and subsequent administration.

Another potential disadvantage of an OCIP is that an owner also assumes the financial risk within the retention layer whether that be through a self insured retention or large deductible. Currently, the majority of OCIP programs include deductibles ranging from $250,000 to $1,000,000 per claim. Although that risk can be passed back among all parties to a project, it is the owner's responsibility in terms of the OCIP policy/carrier. Consequently, if claim frequency and costs exceed project estimates the owner's OCIP costs increase.

D. Benefits of an OCIP for a Contractor.

OCIPs provide benefits for contractors as well as owners. The primary benefit to contractors is that OCIPs may allow them to work on a project which they might not be able to properly insure without the OCIP. For instance, an OCIP may allow a small contractor to enjoy coverage on a large job that he otherwise would not have been able to insure. This can lead to profits, work experience and standing, for that contractor that otherwise it would not have been able to obtain.

An OCIP also implements a broad risk management program administered by the owners and their risk consultants, which can complement the existing safety programs of participating contractors and help standardize safety procedures throughout the job site. An owner is able to add additional safety staffing, implement a financial safety-incentive program, and/or expand periodic audits, by using the costs saved from contractor and subcontractor bid credits and insurance deductions. Uniform safety procedures throughout the site and the additional safety staffing implemented, can result in less injuries to the contractors' employees.

Additionally, contractors often experience improved claims management through OCIPs. The over arching risk management program implemented with an OCIP allows for precise claims handling procedures. Some programs imposed by an OCIP can potentially reduce a contractor's worker compensation costs by estimates of as much as 30 percent. This reduction in cost is achieved by: directing injured employees to preferred provider networks, implementing return-to-work programs and engaging in comprehensive medical bill reviews. Owners can offer these program features to all contractors and subcontractors insured through the OCIP. This provides a significant advantage to small contractors who would normally not benefit from these programs through traditional, individual insurance programs.

Finally, OCIPs often reduce the disputes between the various contractors on a particular project. By covering all contractors associated with a single project, certain coverage and subrogation issues that may arise between contractors and insurers are eliminated. On projects where the traditional approach to insurance is used, the owner, general contractor and subcontractors each have separate policies with respect to the project, and are likely to be represented by different insurers and attorneys for claims and/or litigation. For OCIPs, a single insurer removes the potential for conflict that exists in the traditional approach where multiple insurers and attorneys are involved. Additionally, claims management that results in civil litigation becomes far more streamlined. Therefore, an OCIP helps mitigate and lower the cost of associated claims handling as only one insurer provides insurance for the entirety of the enrolled parties.

E. The disadvantages of an OCIP for a Contractor.

The primary risk for contractors and subcontractors under an OCIP is that the coverage afforded may have certain gaps that will not sufficiently cover them for future losses. Although OCIPs are primarily designed to provide coverage for all work performed on a site, coverage is generally subject to significant exclusions which may result in narrow coverage compared to that which a contractor may otherwise obtain in the traditional model of insurance. For instance, coverage under an OCIP does not extend to a contractor's work performed offsite. Contractors thus need to exercise extreme care in screening coverages afforded under a proposed OCIP. If the OCIP is deficient, the contractor will need to contact its own insurer to obtain excess or Difference–In–Conditions ("DIC") liability coverage.

Also, certain OCIP policies hold contractors and subcontractors responsible for deductibles for damage or loss attributed to them. To avoid continuing and costly losses, a contractor should take reasonable steps to insure that only a single deductible will be assessed by the owner for a loss which may occur over an extended period of time.

Contractors may also experience a decreased volume discount from working on an OCIP project. Because the contractor is not purchasing insurance from its own insurer for the OCIP project. the work done on the OCIP project may minimize the volume discount for insurance which the contractor would have realized had the project been done in the traditional risk-allocation model.

Finally, OCIP projects tend to be much more document and report intensive, which can place additional reporting and administrative burdens on a contractor or general contractor. This includes a more complicated bidding process which generally require the contractor to demonstrate that insurance has been removed from the bid.

III. OCIP 2.0: The Contractor Controlled Insurance Program

Although currently not as prevalent throughout the United States, CCIPs are wrap policies that involves essentially the same framework as that associated with an OCIP. As such, the majority of principles, benefits and disadvantages associated with OCIP policies apply equally to CCIPs.

Similar to an OCIP, a CCIP involves a "major contractor," normally the general contractor, obtaining global insurance for any losses sustained as a result of the construction job and on behalf of all enrolled contractors at the job site. More specifically, a CCIP can be utilized for a single project, or can cover all projects enrolled into the program on a "rolling basis." A CCIP is deigned to respond to any claims that may arise during the construction period and extend past the completion date to a date certain (oftentimes until the applicable statute of limitations has run). The terms of the CCIP are negotiated between the general contractor and the insurer and oftentimes includes general liability, excess liability and workers compensation covering site risk for not only the general contractor, but also any subcontractors and sub-subcontractors associated with the project. Subcontractors remove associated premium and insurance costs from their bid, and the general contractor applies the associated profit to the purchase of the CCIP itself.

A CCIP can provide many of the same benefits as an OCIP for a general contractor able to manage additional risks and the heightened administrative burden associated with this type of wrap up policy. For instance, through the implementation of a CCIP, a contractor may reduce project insurance costs through strenuous loss control and claims management procedures. The associated costs savings can be then applied to increase industry competitive, profitability or both.

Like OCIPs, however, the use of a CCIP also involves the assumption of certain risks by the contractor. Currently, the majority of CCIP programs include deductibles ranging from $250,000 to $1,000,000 per claim. Although total deductible losses are typically be capped, general contractors often find it difficult to charge the maximum loss cost to its projects and still remain competitive. As such, for a general contractor, failing to control losses may result in significant financial loss.

Additionally, failing to place a sufficient volume of projects through "rolling" CCIPs can pose a financial risk for contractors. Currently, underwriters may charge a fixed minimum premium estimated at the CCIPs inception. A contractor that fails to run the minimum volume will nevertheless be required to pay the minimum premium. Accordingly, it is essential that contractors have realistic expectations and healthy backlogs to successfully implement rolling CCIPs.

CCIP policies are most ideally suited for contractors who predominately work on large projects, with a steady influx of present and future business and substantial administrative resources at their disposal. Common traits found in contractors with successful CCIPs include:

- Significant administrative personnel to properly handle and analyze the rise of associated paperwork generated through a CCIP wrap policy;

- An established safety culture that is embodied by all employees;

- Prior experience in managing claims associated with a high deductible;

- An advanced subcontractor pre qualification process; and

- A steady book of current and future projects derived from an established client base to meet the CCIP minimum premium requirements.

Ultimately, for large contractors with substantial administrative resource, CCIPs can offer the potential for advanced profits if the contractor is willing to incur the administrative costs and financial risks associated with implementing the insurance model.

IV. The Fine Print: The Importance of Proper Enrollment in Wrap Ups.

As wrap policies are still emerging in the construction and insurance industry, their associated intricacies are often overlooked by the parties involved. This can lead to dire financial consequences for owners, contractors and subcontractors if certain requisite, procedural requirements are not met. For instance, although oftentimes a party will agree to participate in a wrap policy pursuant to the bid contract associated with the work, most OCIPs and CCIPs require participants to actively enroll in the program before coverage is in place.

The importance of a contractor actively enrolling in the wrap policy associated with the contract and abiding by the strict terms of the policy has been highlighted by a number of cases recently issued throughout the United States. For example, a federal district court in Louisiana recently denied a subcontractor's coverage action because the subcontractor did not properly enroll in the CCIP. *Williams v. Traylor-Masman-Weeks, LLC,* No. 10-2309, 2012 WL 1106652, *3 (E.D. La. Apr. 2, 2012). In ruling against the subcontractor, the court reasoned that the insurer was not a party to the contract created between the subcontractor and the general contractor and the plain and unambiguous terms of the wrap policy required all subcontractors to affirmatively enroll in the program to receive coverage. *Id.* at *4. *See also Zurich Am. Ins. Co. v. Ill. Nat'l Ins. Co.*, 940 N.Y.S. 2d 271, 271-72 (N.Y. App. Div. 2012) (subcontractor was not insured under OCIP where the term "contractor" required the execution of a written work agreement and active enrollment in the OCIP and the subcontractor had done neither as of the alleged date of loss).

As recent jurisprudence has followed the express language contained within the four-corners of wrap policies, it is critical for all participants to properly enroll in the chosen program and ensure all necessary steps have been taken to ensure the proper coverage is in effect. Conversely, it is also good practice for owners or contractors to monitor the enrollment status of all project participants before work commences on a site to help avoid not only costly schedule delays, but also claims detrimental to the overall risk management associated with the project.

V. Conclusion

Due to the complex relationships that exist between parties involved in construction contract and the open ended nature of construction liability, developers, contractors and subcontractors are facing new and significant risk challenges on a daily basis. Whether a wrap up policy is the right choice for a project depends largely on the owner's or contractor's willingness to take on the additional responsibilities and risks associated with administering such a program. Despite the associated drawbacks, wrap up policies offer a viable options for owners and general contractors undertaking both commercial and residential construction projects as insurance coverage issues continue to evolve.