



Transferring and Financing Risk in Public Works Contracts

Thursday, September 8, 2022

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TRANSFERRING AND FINANCING RISK IN PUBLIC CONTRACTS

Presented to the League of California Cities®

September 8, 2022

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Transferring and Financing Risk in Public Contracts

When policymakers and decision makers face a hard-to-predict, deeply uncertain future, such as the one facing city leaders today as we traverse the COVID-19 pandemic, it is important to develop a risk management policy that transfers and finances that risk appropriately through sound contracting practices. In this context, “risk” refers to the chance of financial loss where there is uncertainty as to whether a loss will occur, and the extent of potential loss. The activities to be performed under the contract, the business relationships between the parties, and the presence of visitors to a worksite, all create potential risk. Risk is transferred to other entities to control losses, thereby saving money. Ensuring cities are not held responsible for mistakes or errors made by a service provider, contractor, or other party can be critical to protecting the public fisc. The primary value of risk transfer is that it involves little or no cost to your city.

It is nearly inevitable that something will go wrong on any given project. A contract that clearly and specifically spells out before work commences which party is responsible for certain aspects of a project can save a city time and expenses in the event of litigation. Contractual risk transfer is a legally binding way to transfer risk to the party that may be in the best position to control or insure the risks related to the service being provided. It requires one party to agree to take responsibility for liabilities and related financial costs for that party’s services or products provided on behalf of or for the benefit of another party.

Every time your city enters into a contract, it should therefore:

- 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.

This paper will focus on different types of contracts and how to evaluate and transfer risk. And it will explain how your city can finance risk by requiring contractors to buy insurance, provide defense and indemnity, or show that they have the financial resources to pay for claims that arise from their work.

Evaluating Risk

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

Each type of contract is accompanied by different times of potential risks. For example, in agreements to purchase goods and services, when does ownership (and risk of loss) transfer to your city? If the product proves defective, who pays to correct the defect or any damages arising from it? (Historically, that risk is passed to others at appropriate times, e.g., the Uniform Commercial Code at Section 2-319 allows parties to transfer title to goods using common terminology such as “free on board” or “fob” meaning title shifts from seller to buyer as soon as the goods are transferred to a third-party for delivery.) For instance, when buying electronic equipment, it is wise to say in the contract that ownership does not change until the equipment is installed, has passed a series of operational tests, and has been formally accepted by the city. Further, many products have a warranty, and your contract should say who will repair defective equipment – typically, cities require the vendor to assume responsibility for repairing or replacing defective equipment. The vendor may, in turn, transfer this responsibility to the manufacturer. For public works contracts, who pays for bodily injury or property damage to a third party if an accident occurs during the project? And for professional services, who pays for design or construction management errors or omissions and their resultant damages?

The following are some issues to consider as cities evaluate 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?

Transferring Risk

Risk transfer ensures that contractors take on their fair share of liability and that cities aren’t culpable for losses that are out of their control. Risk transfer is critical to reducing a city’s exposure, regardless of the size or scope of a project. Even small, seemingly straightforward contracted work can open cities up to liability if the proper precautions aren’t taken.

Unfortunately, just because a business requires its third-party partners to carry insurance or sign a contract doesn’t mean the business is adequately covered should a loss occur. For instance, a contractor’s insurance might not appropriately cover certain risks. Or a contractor’s insurance limits might be inadequate to provide protection following a loss. Some contractors have even been known to lie and say they have insurance in place when they don’t, or their coverage might cancel for nonpayment during the project. Consequently, even when working with contractors they know or trust, cities cannot rely on handshake agreements that offer no protection in the face of a claim.

In these instances, cities would be left to pay all damages following a loss, which, depending on the severity of the claim, could be significant. Thankfully, there are ways that cities can secure additional layers of protection when transferring risk.

Generally, contractual risk transfer has three common components:

1. Insurance procurement, including obtaining Certificate of Insurance and, where possible, key endorsements and/or a copy of the insurance policy itself;
2. Hold harmless / indemnification / defense agreement;
3. Waiver of subrogation

In most cases, California cities can transfer losses that are partly their fault, but cannot transfer losses that are solely their fault. Therefore, in drafting risk transfer agreements, it is important to avoid overly broad agreements that may be unenforceable. Your contract should be as specific as possible regarding the scope of work and what each party's financial responsibilities are.

Financing Risk

Risk financing activities are part of financial management and include:

- Arranging for sources of funds to pay for losses that may occur; and
- Using those fund sources when needed.

When your city transfers risk to a contractor or other entity, you must make sure they can pay for any losses that arise out of their operations. While not perfect, insurance is often the most reliable risk financing method available.

Insurance

Insurance is a contractual arrangement to transfer and distribute risk in exchange for a fixed charge (insurance premium). Securing an insurance policy is one of the most common risk transfer strategies. By providing coverage for a specific risk, an insurer agrees to assume strictly defined financial risks on behalf of the policyholder. Cities can also transfer risk through contracts, specifically ones that include additional insured requirements.

Additional Insured

If insurance is used to finance potential loss payments, it is critical that as a routine part of their contracts, cities request to be named as additional insureds on the policies carried by their contractors and vendors.

When a city is named an additional insured on a liability insurance policy a contractor buys, the insurer:

- Must provide a defense if your city is named in suit;
- Must pay your 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

Requiring contractors or service providers to buy insurance is a means to finance loss payments. Thus, if something goes wrong with a contractor's work and the city is sued for damages, the city will be covered by the contractor's policy (unless an exclusion applies). In particular, cities should secure additional insured status on their contractor's commercial general liability, automobile, and umbrella policies, accounting for both ongoing and completed operations. Additionally, it's crucial that cities clearly outline minimum insurance requirements and limits, as well as minimum acceptable standards for their contractors' insurance carriers (many require an A. M. Best Company rating of A-, VIII¹ or better). This is especially true when you consider that contractors might secure coverage from nonstandard insurance carriers that could exclude primary liability exposures.

In some cases, pollution liability or professional liability should also be required. And for construction projects, cities should also require Builder's Risk / Course of Construction insurance in an amount that matches the price for the Project.

Above all, general acceptance provisions must clearly indicate that by beginning work, the contractor accepts the terms of the contract. These provisions should also detail how long they remain in effect (e.g., until the work is completed and accepted by the city).

Notably, status as an additional insured 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. The limit of liability is the most an insurance policy will pay for a loss.

¹ AM Best uses both qualitative and quantitative measures to assess an insurance company's ability to pay claims and meet its financial obligations. AM Best's financial strength ratings range from the highest A++ to B+, to 10 vulnerable ratings, ranging from B to S, with the lowest indicating a rating was suspended. AM Best assigns each rated (A++ through D) insurance company a Financial Size Category (FSC). The FSC is based on adjusted policyholders' surplus (PHS) in U.S. dollars and may be impacted by foreign currency fluctuations. Thus, a rating of A-, VIII indicates an A-rated insurance company (one that's considered highly likely to repay creditors and pay any claims presented) with an FSC of VIII (PHS between \$100–\$250 million).

- If a claim is not covered or the contractor does not have enough insurance, the hold harmless and indemnity agreement gives your city the right to be reimbursed by the contractor.

Your city will have more financial security if you combine hold harmless and indemnity agreements with insurance.

Cross-Liability Coverage

It is also important to make sure that liability insurance provides coverage for cross liability, which is often found in a separation of insureds condition in the policy. Cross liability coverage has two basic benefits:

1. The insurance applies separately to each insured against whom claim is made or suit brought, and each insured is entitled to a separate defense. Consequently, your city, as an additional insured, is entitled to coverage even if another insured has done something to cause the insurer to deny their coverage.
2. It allows one insured to make a claim against another insured. This coverage is very important if your city is named an additional insured under a policy. Without cross liability coverage, your city (as an additional insured) would not be indemnified by the contractor's liability insurance coverage if the city made a claim against the contractor.

Claims-Made vs. Occurrence Coverage

Most general liability policies provide occurrence coverage. This means that a claim can be made today for an injury or damage that occurred 20 years ago. The insurer will investigate and settle the claim as long as the injury or damage occurred during the policy period and is covered by the terms and conditions of the policy. For these reasons, occurrence coverage is usually the best option.

Claims-made coverage is different. If a contractor buys claims-made coverage, the claim must be first made during the policy period (or an extended reporting period described in the policy). Additionally, the injury or damage must occur before the end of the policy period.

Because of the different nature of these coverages, if coverage is provided by a combination of CGL (typically occurrence coverage) and excess or umbrella insurance (typically claims-made coverage), a city should require the coverage trigger be the same for the underlying and excess or umbrella policies. Such a requirement will help avoid gaps in coverage.

Requirement That Contractor's Insurance Will Respond First Following a Loss

If a loss occurs as a result of a contractor's work, it's important that the contractor be held accountable. Thus, contracts should explicitly state that the contractor's insurance – whether it be general liability, automobile, or umbrella coverage – must pay for claims first on a primary and noncontributory basis, which means that the contractor's insurance must pay first and its limits be exhausted before the city's insurance is accessed, and the contractor's insurer may not seek contribution from the city's insurer.

Requirement That Contractor Impose Contractual Requirements on Its Subcontractors

Because contracts between a prime contractor and its subcontractor are private contracts, there is no privity of contract between such subcontractors and the city hiring the prime contractor, such that the rights and obligations agreed to in the prime contract are not automatically extended to the subcontractor absent a "flow down" clause.

To minimize the prime contractor's cost and performance risk as well as obtaining required information, it is important to include a flow down clause requiring the contractor to incorporate into any subcontracts key contractual requirements between the city and the general contractor. A flow down to another party binds the subcontractor to the terms and conditions of the flow downs which are typically the same as the prime contract, but can be altered by the parties involved. Required flow downs that are altered must contain the substantive issues of the original clause. The flow downs need to have the parties named in the flow downs re-identified so that the prime contractor rather than the city is identified as buyer.

Waiver of Subrogation

A Waiver of Subrogation is an endorsement that prohibits an insurance carrier (that steps into the shoes of the insured after it pays a loss) from recovering the money it paid on a claim from your city even if it caused the loss. A city may require this endorsement from its contractors to avoid being held liable for claims that occur on their jobsite. Waiver of subrogation provisions found in contracts are generally upheld by courts.

Such clauses as to workers' compensation coverage require a contractor to pay an additional premium and to provide payroll data as to the specific workers and hours worked under the contract to which the waiver applies. Such coverage is essential when the contractor's employees will interact with city employees and property in a way that creates a risk that a workers' compensation-covered injury to the contractor's employees might arise in part from culpability of the city. Such coverage is not nearly as valuable in other settings, like off-site provision of professional services, and can be very burdensome to contractors because when an insurance carrier cannot recoup the expenses that were paid out for an employee's injury that resulted from an outside third party's negligence, the full amount of such a claim goes into the contractor's Experience Modification rate (EMR), which can cause an increase in workers' compensation costs

for the subsequent three-year period that this claim is part of the EMR. Many professional services firms refuse to waive subrogation on workers' compensation coverage for this reason.

Certificates of Insurance

A certificate of insurance is not a copy of a contractor's insurance policy, and does not amend the underlying insurance policy, but rather is simply a description of the insurance coverage in force at that time. A Certificate of Insurance serves as evidence that the contractor actually procured the type and coverage of insurance required by the contract. Certificate holders hold proof of insurance, or certificates of insurance (COIs), from insureds they are working with while additional insureds are those who have coverage extended to them through the "named insured's" policy. COIs do not change an insurance policy in any way or give the certificate holder the ability to make a claim on the policy; they simply show proof of coverage at that moment. Notably, such certificates bear the following important warning:

THIS CERTIFICATE IS ISSUED AS A MATTER OF INFORMATION ONLY AND CONFERS NO RIGHTS UPON THE CERTIFICATE HOLDER. THIS CERTIFICATE DOES NOT AFFIRMATIVELY OR NEGATIVELY AMEND, EXTEND OR ALTER THE COVERAGE AFFORDED BY THE POLICIES BELOW. THIS CERTIFICATE OF INSURANCE DOES NOT CONSTITUTE A CONTRACT BETWEEN THE ISSUING INSURER(S)' AUTHORIZED REPRESENTATIVE OR PRODUCER, AND THE CERTIFICATE HOLDER.

This is why it is important to require the contractor or vendor to provide the actual endorsements providing the important coverages to the city (such as additional insured coverage, primary and noncontributing, subrogation waiver, notice of cancellation, etc.) or the entire policy.

Additional insured status gives coverage to parties not originally named in the policy. An additional insured is somebody who benefits from the coverage of another's policy; this includes the ability to make claims under the policy, including for a defense to third party claims under a commercial general liability (CGL) policy. A certificate holder can request to be an additional insured on the policyholder's policy and this would be shown in the certificate of insurance.

General descriptions may also qualify as an additional insured through a "blanket additional insured endorsement." This is as "an insurance policy endorsement that automatically provides coverage to any party to which the named insured is contractually required to provide coverage." Such blanket provisions often provide additional insured coverage automatically to persons and entities to the extent the named insured agrees to do so under a written contract, or as required to obtain a permit.

When a city is added to a policy as an additional insured, the city can claim against the insurance policy in case it is sued for the contractor's actions, and is covered according to the contractor's policy. This means the contractor's policy will pay any covered claims or damages related to the additional insured and even defend claims.

In summary, there is a major difference between a certificate holder and an additional insured. If the city is entitled to coverage based solely upon the liability assumed under the contract, the city is not "insured." Rather, the contractor has protection for liability it has assumed by contract. This obligates the insurer to indemnify the contractor, who can then use the funds to reimburse the city.

Conversely, as an additional insured, the city is entitled to all insurance policy benefits including a right to defense and the right to look to the insurer directly rather than through the contractor, and to enforce an implied covenant of good faith and fair dealing.

When reviewing a certificate of insurance, pay attention to when the policy will expire. You'll want proof of the renewal of coverage at that time to ensure both parties stay protected. As explained in more detail in the Insurance Archaeology discussion below, it is helpful to also require a copy of a contractor's insurance policy in addition to requiring a Certificate of Insurance.

Hold Harmless / Indemnification Clauses

Cities can also transfer risk through contracts, specifically ones that include an indemnity clause and a hold harmless agreement. By signing a contract that includes these clauses, a party is essentially agreeing to defend and pay costs and expenses on behalf of the other party under certain circumstances. It's worth noting that indemnification agreements are independent of insurance (and most say so expressly) and work by transferring legal liability from one party to another.

Indemnification

Indemnification is the practice of guaranteeing a third party claim against your counterparty. If in the course of carrying out a project, a contractor causes a third party to be injured, the injured third party will likely sue both the city and the contractor seeking compensation for personal injuries. Both the city and the contractor may have liability in some proportion as a result. However, if your contract required the contractor to indemnify the city for any third party claims that arose in the performance of the contract, the contractor will bear full liability for the damages because it indemnified the city for the loss.

California courts have attempted to group indemnity clauses into categories. In *MacDonald & Kruse v. San Jose Steel Co.* (1972) 29 Cal.App.3d 413, the court distinguished three "types" of indemnity clauses. "Type I" involves language in which the party providing the indemnity (the "indemnitor") agrees to protect the party receiving that protection (the "indemnitee") for all claims, including those caused by the negligence of

either the indemnitor or indemnitee. This is the strongest of the three types of clauses. To achieve such broad coverage, the obligation must be stated in explicit terms in order to be enforced.

A second category of indemnity is “Type II,” or “general” indemnity in which the indemnitor protects against only its own negligence. Such a clause can be voided by the indemnitee’s “active” negligence. Thus, if the indemnitee is actively negligent, the indemnitor is able to avoid liability for any obligation based on the contractual language.

The final category is “Type III,” in which the indemnity extends only to the negligence of the indemnitor. Such a clause can be voided by even passive negligence on the part of an indemnitee.

Importantly, another leading case, *Rossmoor Sanitation, Inc. v. Pylon, Inc.* (1975) 13 Cal. 3d 625 clarifies that courts interpreting indemnity provisions must look to the actual intent of the parties. In most instances, when public agencies enter into contracts, they normally use Type I or II clauses. However, in keeping with *Rossmoor*, they must ensure that the language of the contract clearly expresses the desired intent.

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. The 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

If a city purchases goods, and the agreement with the seller requires the seller to obtain required shipping permits, but also includes a hold-harmless clause for any acts of negligence on the seller’s part, the city will be unable to recoup any costs or losses for delay or damages if the seller fails to obtain the required permits.

Cities should require hold harmless clauses whereby the other party agrees not to hold the city legally responsible for the risks involved in certain services. Where two local agencies form an agreement, a more limited hold harmless agreement may be equitable.

Hold harmless agreements are nearly always combined with indemnity agreements because third parties can sue one or all parties for negligence, either jointly or separately. Without an indemnity agreement, a party that is held harmless by the entity they are contracting with may end up paying damages to a third party claimant.

The differences between indemnification and a hold harmless agreement are:

- A hold harmless agreement may require a party to protect against actual losses as well as potential losses while indemnification protects only against actual losses.
- A hold harmless agreement is primarily directed at claims between the parties to the contract whereas indemnity agreements allocate risk and responsibility to pay third party (tort) claims.

A hold harmless and indemnity agreement will not work unless the party that accepts risk has the financial resources to back up their commitment. Therefore, when transferring risk to another entity, it is important to ensure that entity has the financial resources or appropriate insurance coverage to finance loss payments.

Duty to Defend

An agreement to defend brings many additional considerations. Essentially, it means that the obligated party will assume the costs and burden of defending the other. It is possible, however, to negotiate different rules for who funds the defense, who controls it, and whether settlement or strategy requires advising the other party or obtaining their consent. Unless negotiated otherwise, both parties may fund and control the litigation, including authority to settle.

Contractually, therefore, the parties can assume certain obligations before any factual determination is even made as to the validity of a third-party's claim. The obligation to defend a counterparty is an affirmative agreement to assume and fund defense, not an option for that counterparty to seek contribution for defense costs only after the court issues a decision on a third-party claim—unless written that way. If the parties dispute whether a duty-to-reimburse-defense-costs clause applies, that yields yet another costly arbitration or trial.

Indemnity clauses are often intertwined with additional insured clauses which require the subcontractor to amend its liability policy to make the owner or general contractor an insured under the policy. An example of such a clause is as follows:

The Contractor shall cause the commercial liability coverage required by the Contract Documents to include (1) the City, the City's lender(s), the City's landlord, the Architect and the Architect's Consultants as additional insureds for claims caused in whole or in part by the Contractor's negligent acts or omissions during the Contractor's operations; and (2) the City as an additional insured for claims caused in whole or in part by the Contractor's negligent acts or omissions during the Contractor's completed operations.

Limitation of Liability

Another factor to consider is the size of the obligation being assumed. Without a clear limitation of liability clause, which is probably the second-most hotly contested contract term, the size of these obligations is difficult or impossible to estimate. Fixing liability at the value of the contract provides the guarantor with an assurance that they will at least not lose more than they could have gained. This may be unacceptable to the guaranteed party though, because it is not hard to imagine a scenario where the damages caused could surpass the value of the contract. Consider elevator maintenance or a contract for a fireworks display, for example — perhaps small contracts, but involving very large risks. Determining a limit that addresses the concerns of each party is a challenging exercise, and no two transactions will have exactly the same set of pressures. The starting points are obvious—the guarantor wants a low limit, while the guaranteed wants no limit—but after that, the variables are highly individual.

One strategy that may help brings the two ends together on both indemnity and liability limitation is imposing mutuality of obligation. This forces each party to put themselves in the other's shoes and leads to less extreme positions. This is not a panacea because there are many situations where the dynamics make mutuality impractical or at least extremely unattractive, but when it applies, it helps to circumvent a very difficult topic. This is the typical approach in contracts between public agencies.

Risk transfer is particularly useful for any contractor engaging in subcontracted work. This is because risk transfer ensures that subcontractors take on their fair share of liability and that businesses aren't culpable for losses that are out of their control. Trade contractors may also subcontract work to others. These agreements specify that cities will not be held liable for losses that stem from a contractor's or subcontractor's work. Importantly, hold harmless and indemnification agreements may be unenforceable if contractors bear the sole responsibility for a city's own negligence.

Although California enacted a new law limiting indemnification obligations, including the duty and cost to defend, that can be imposed on design professionals, the parties may still agree to contractual provisions, clauses, covenants or agreements that are not expressly prohibited by Civil Code section 2782.8. And a design professional may still be required to pay defense costs proportionate to its percentage of fault. Importantly, professional liability insurance policies often will only pay to the extent of the insured's negligence. Therefore, a hold harmless and indemnity agreement may create obligations that are broader than the scope of the contractor's insurance coverage.

In addition, the limitation to the duty and cost to defend does not apply: (i) where there is a project-specific general liability policy insuring all project participants for general liability exposures on a primary basis and also covering design professionals for their legal liability arising out of their professional services on a primary basis; or (ii) to written design-build agreements.

Navigating Anti-Indemnity Laws

California's long-standing anti-indemnity laws prohibit a public agency from forcing a contractor to indemnify the agency for its "active negligence." At the beginning of 2013, that prohibition was expanded in new and amended anti-indemnity statutes, which protect subcontractors and suppliers of goods and services (not just contractors) and prevent certain private owners (not just public agencies) from enforcing an indemnity for their own "active negligence".

The new laws also contain additional protections for subcontractors. Now, in many situations, a subcontractor entering into a construction contract after January 1, 2013 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.

California's new anti-indemnity laws and subcontractor protections are nuanced and depend on whether the project is public or private, residential or nonresidential, and the role of the indemnifying and indemnified participants on the project. Unfortunately, these new laws are not always clear and consistent. Parties attempting to navigate through these new laws risk disputes and litigation. Adding to this uncertainty is the fact that while some of these protections can be addressed by the parties through contract negotiation, others cannot be waived or modified.

Force Majeure

A force majeure ("Act of God") clause allocates the risk of loss if performance is hindered, delayed, or prevented because of an event that the parties could not have anticipated or controlled such as floods, fires, strikes, acts of war, etc. It provides a contractual defense, the scope and effect of which will depend on the terms of a particular contract. With the advent of the COVID-19 pandemic, it is crucial in contract negotiation 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 and health programs foster a proactive approach to "finding and fixing" workplace hazards before they can cause injury or illness. Rather than reacting to an incident, management and workers collaborate to identify and solve issues before they occur. This collaboration builds trust, enhances communication, and often leads to other business improvements. Employers who have implemented safety and health programs have also found that managing for safety results in higher-quality product or output and higher profits.

For these reasons, safety requirements should be a vital part of bid specifications. And 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

A bond is a three-party agreement between the principal (typically contractor), surety (the issuer of the bond), and obligee (typically your city). The surety guarantees to the obligee that the principal will fulfill the underlying obligation. Construction bonds, also called contract and surety bonds, are frequently used in the construction industry. Different types of construction bonds cover different obligations, below are four of the most frequently used.

Bid Bonds

For public works projects, contractors bid for construction contracts. California cities are statutorily required to obtain bid bonds from contractors before accepting the bid and awarding the contract. Bid bonds protect the city by guaranteeing successful bidder will honor its original bid amount when entering the contract. If the contractor fails to do this, both the “principal” and surety may be liable for the incremental costs of contracting with a replacement contractor, up to 10% of the bid price. Importantly, a bid bond may not respond if the bidder has legitimate reasons to withdraw a bid – such as a mistake.

Payment Bonds

Payment bonds are required under federal law (the Miller Act) for public works contracts in excess of \$100,000 and under California law for public works projects exceeding \$25,000. Payment bonds guarantee all employees, subcontractors and material suppliers hired to help on a project by the “principal” are properly paid for their contributions. So, in the case of payment bonds, the “obligees” are the subcontractors and suppliers. If they fail to get their due payments, the surety is liable for reimbursing them. In most cases, the contractor will then be obligated to reimburse the surety. Without this protection, these individuals could be left with unpaid wages or other debts if the project they were working on was cancelled for some reason. A private property owner may be left with a laborer’s or materialmen’s lien on its land and should not release the protection of a payment bond until lien releases are in hand. A public agency may be left with a Stop Payment Notice and should not release the project retention or the protection of a payment bond until lien releases are received. Importantly, payment bonds also cover the obligation to pay prevailing wages.

Performance Bonds

Performance Bonds guarantee that a contractor will complete a project according to the terms of the construction contract. Performance bonds protect cities from contractors’ low quality work or non-completion. If the “principal” abandons a project before completion, or completes the project unsatisfactorily or late, the surety may be liable to

either complete the contract, contract a replacement contractor, or compensate the “obligee” for finishing the project. Many performance bonds automatically include a maintenance bond (described below) for one year without additional charge.

Performance bonds also protect the owner from substandard work, or work that doesn't meet the contract requirements since it guarantees satisfactory completion of a project by a contractor. It protects the city in case the contractor fails to complete the contractual obligations. They are usually required on county public projects, are recommended on all public projects, and can also be requested by any private owner. These bonds are held by the city as obligee, with the general contractor or a subcontractor as the principal.

Often, obtaining a bid bond pre-qualifies the bidder for a performance bond because if a surety issues a bid bond, it has determined that the principal has the resources to bid on a contract. Thus, if a surety backs a bid, it probably will also issue a performance bond.

Maintenance Bonds

Maintenance Bonds are a type of surety bond purchased by a contractor that protects the city once a construction project is completed. Maintenance bonds are in place for a specified time period against defects and faults in materials, workmanship, and design that could arise during a “warranty” period.

Note that sureties do not happily pay claims and it may take a lawsuit or a threat of one to enforce a surety bond. Moreover, you get only what the surety bond specifically provides for. It is advisable to review them closely and to put the surety on notice as soon as a problem with a contractor begins to develop and it is clear the contractor will not quickly resolve it. The surety holds collateral of the contractor and bonding capacity is an essential element of a contractor's business capital. Thus, involving the surety can bring large pressure to bear on a contractor.

Insurance Archeology

A largely untapped resource for funding public agency risk is insurance archaeology. Historic insurance policies may be old, but many still provide coverage to this day. Even policies over 100 years old can still be viable for providing coverage for present day liabilities. If the actual damage for a claim occurred during the old policy's term, then it's possible for the current-day claim to be covered by the old policy because there is no statute of limitations on liability. Even for claims discovered years or decades later, the insurance provider may be responsible for the damage that took place during those coverage periods.

Historical insurance can yield millions in coverage for a wide variety of cases including environmental claims (CERCLA, Superfund, Polanco/Gatto Act, asbestos, e.g.), nuisance and trespass claims, landslides, subsidence, and flood claims, as well as various regulatory orders including investigative orders, cleanup and abatement orders, total maximum daily load limitations on discharges to receiving waters, and sediment quality

objectives. Site cleanup, compliance obligations, and third party legal actions can hold those liable for millions in remediation costs. Luckily, the liable party can prove that they have coverage by locating valuable old policies that may still be in effect. Thus, finding historical policies that cover expensive remediation costs can be a huge boon for a city.

It's common for historical insurance to be lost or destroyed. This happens for many reasons, including changes in the insurance industry, policy changes, business relocations, mergers and acquisitions, and personnel changes. Old documents that employees believe are no longer valuable can be tossed out, or a company might not even realize they have insurance because it was purchased as part of a package.

Insurance archeology locates or reconstructs missing or destroyed historical insurance. Various insurance archeologists are experts at finding coverage for businesses that have misplaced or destroyed old policies that are still in force. Locating the actual policies or finding evidence of them can help to offset pricy remediation costs.

Notably, the older an insurance policy is, the less restrictive and more valuable it is likely to be. Before the 1970s, it was unlikely that policies contained pollution exclusions, making the insurance provider rather than the policy holder liable for pollution damage. By 1985, an absolute pollution exclusion was more frequently enforced. This makes older insurance policies generally more valuable than newer, more restrictive ones.

Soil and groundwater contamination aren't the only claims that historical insurance can cover. Asbestos, chromated copper arsenate, and construction defect liabilities are all potential threats to property owners. Fortunately, historical policies can be used to cover these as well as other types of claims.

Even if original policies cannot be located, secondary policy evidence can still be used to reconstruct them. Insurance archeologists can frequently identify secondary evidence that can be used to prove the existence and terms of old policies. Different jurisdictions have different restrictions for what counts as secondary evidence, but there are resources available to assist in these cases.

If damage occurred over a long period of time, multiple policies may apply. For example, some states have ruled that policy holders, in addition to being covered by the policy in effect at the time the damage was first discovered, can also receive coverage from policies in effect during the time damage was occurring. This leads to multiple policies providing coverage for the same long-term damage and all prior policies issued back to when coverage first began.

In summary, it is important to keep historical insurance policies safe and accounted for. They are lifelines when it comes to managing risks against costly environmental liabilities. If you need to locate lost or destroyed historical insurance, an insurance archeologist can likely help because they compile databases of insurance policies dating back decades.

Conclusion

There are myriad tools available to municipalities to reduce risk in public contracts, from analysis and reduction of risk in initial negotiations, to transferring risk, to financing risk, that yield opportunities to preserve the public fisc in a variety of contracting scenarios.